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Identifying Section 306 Stock: The Sleeping Beauty of Revenue Ruling 66-332

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IDENTIFYING SECTION 306 STOCK: THE SLEEPING BEAUTY OF REVENUE RULING 66-332

*Saul Levmore**

IN 1920 in *Eisner v. Macomber,*[1] the Supreme Court held that a pro rata common stock dividend was not income within the meaning of the sixteenth amendment because it did not represent a shift of value from the corporation to its shareholders.[2] In subsequent cases, the Court changed the focus of its analysis and held that *Eisner* applied only to stock dividends which did not affect the proportionate rights and interests of the shareholders.[3] This proportionate interest test was interpreted by the Court of Appeals for the Sixth Circuit in *Chamberlin v. Commissioner*[4] to allow a "preferred stock bail-out."

In a typical preferred stock bailout, the shareholders in a profitable corporation arrange a dividend of preferred stock on common with the intent of selling the preferred to outsiders followed, perhaps, by a redemption of the preferred. The shareholders' goal is to receive cash taxable at capital gain rather than ordinary rates while maintaining their equity interest in the corporation.[5] In *Chamberlin,* the shareholders arranged a pro rata preferred dividend on common and immediately sold the preferred to insurance companies. The corporation agreed to redeem the preferred over a seven year period.[6] The Sixth Circuit held that a bona fide stock dividend that did not alter the shareholders' preexisting proportionate interests or increase the intrinsic values of those interests was not taxable under *Eisner* and that the timing of subsequent dispositions of the stock was immaterial.[7] In response to *Chamber-*

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[1] 252 U.S. 189 (1920).

[2] *Id.* at 211, 219.

[3] *See* Helvering v. Sprouse, 318 U.S. 604, 607 (1943); Helvering v. Griffiths, 318 U.S. 371, 375 (1942); Koshland v. Helvering, 298 U.S. 441, 445-46 (1935).

[4] 207 F.2d 462 (6th Cir. 1953), *cert. denied,* 347 U.S. 918 (1954).

[5] *See generally* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 10.01 (4th ed. 1979) [hereinafter cited as Bittker & Eustice].

[6] *See* 207 F.2d at 464-65.

[7] *Id.* at 469-70.

lin, Congress enacted section 306 of the Internal Revenue Code.[8]

This article focuses on the features of section 306 stock that distinguish it from common stock, and not on the complicated details of section 306[9] or on the many policy and planning issues it stimulates.[10] The article first considers the purpose and mechanics of section 306 in a general manner. It then discusses several revenue rulings that have attempted to identify the distinguishing features of section 306 stock and suggests alternative approaches that are more effective in preventing bailouts of earnings and profits. Finally, the article examines a recently modified and disfavored revenue ruling in detail and considers its possible effect as a deterrent to self-dealing corporate fiduciaries. It concludes that the Internal Revenue Service's original treatment of the recapitalization at issue was superior to its modification, both from a tax and corporate law perspective.

I. The Distinctive Effect of Section 306

Section 306 is a distinctive landmark in the corporate tax landscape.[11] It is a wait-and-see remedy for the preferred stock bailout in that, while the stock is tainted at issue,[12] dividend taxation is imposed only upon disposition of the preferred stock.[13] Alterna-

[8] I.R.C. § 306.

[9] For an exhaustive review of the mechanics of § 306, see Alexander & Louis, *Bail-Outs and the Internal Revenue Code of 1954*, 65 Yale L.J. 909 (1956).

[10] *See generally* Lowe, *Bailouts: Their Role in Corporate Planning*, 30 Tax L. Rev. 357 (1975).

[11] *See generally* Bittker & Eustice, *supra* note 5, ch. 10.

[12] *See* I.R.C. § 306(c). Section 306(c) provides, in relevant part:

> (c)Section 306 stock defined.—
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> (1) In general.—For purposes of this subchapter, the term "section 306 stock" means . . . .
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> (A) Distributed to seller.—Stock (other than common stock issued with respect to common stock) which was distributed to the shareholder selling or otherwise disposing of such stock if, by reason of section 305(a), any part of such distribution was not includible in the gross income of the shareholder.

Id.

[13] *See id.* § 306(a). Section 306(a) provides, in relevant part:

> (a) General Rule.—If a shareholder sells or otherwise disposes of section 306 stock . . . —
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> (1) Dispositions other than redemptions.—If such disposition is not a redemption . . . . —
>
> (A) The amount realized shall be treated as ordinary income.
>
> . . . .

tively, the bailout potential could have been stifled by imposing dividend treatment at the time of the preferred stock dividend.[14] Congress, however, appears to have been sensitive to the utility of preferred stock in intergenerational transfers of corporate ownership.[15] In this familiar context, an older generation uses a recapitalization to secure for itself a source of retirement income in the form of preferred dividends and liquidation rights. Younger newcomers, meanwhile, reduce their initial capital needs, but are able to obtain voting control and bear the long term economic risks presented by the firm because they own all the common stock. If Congress had decided to tax preferred stock dividends upon distribution, the intergenerational transfer of some businesses might have been impeded. For the most part, attempts to exploit this congressional sensitivity, by selling previously distributed preferred stock and claiming capital gains treatment, are stymied by the wait-and-see strategy of section 306 which reasserts the ordinary income tax at the time of disposition.[16]

The distinctive treatment of section 306 stock lies in contrast to, and in compromise of, the alternative treatments of common stock and debt. A common stock dividend also could be used to bail out earnings and profits at capital gain rates if a willing investor could be found to purchase an equity interest in the enterprise.[17] In fact, a stock dividend is hardly necessary; earnings and profits are bailed out daily by sales of stock of corporations that have retained

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> (2) Redemption.—If the disposition is a redemption, the amount realized shall be treated as a distribution of property to which section 301 applies.

Id.

[14] Prior to *Chamberlin,* the Service had some success discouraging bailout devices by refusing to rule that a dividend of preferred stock was nontaxable if a sale of the dividend shares was contemplated. *See* Bittker & Eustice, *supra* note 5, at ¶ 10.01.

[15] *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 42, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4621, 4673. The Senate Finance Committee expressed an intent to "liberalize" the law with respect to "cases which involve mere rearrangements of corporate structure" while at the same time taxing distributions which are in substance (if not in form) dividends at ordinary rather than capital rates. *See id.*

[16] The wait-and-see strategy of § 306 is repeated in the Code's treatment of distributions that are coincidental with reorganizations. Bonds and common stock are treated as they are when directly distributed (with important modifications not relevant here, *see* I.R.C. §§ 354-356), while § 306(c)(1)(B) defines section 306 stock to include such stock received in a corporate reorganization, *see id.* § 306(c)(1)(B).

[17] *See id.* § 305(a). Section 305(a) provides that stock distributed with respect to the issuer's stock generally is not included in gross income. *See id.*

their earnings rather than distributed taxable dividends. Presumably, preferred stock dividends are treated more harshly because investors are more willing to buy promises of a certain and preferential nature and because owners are less eager to sell stock when they must part with voting rights.[18]

On the other "side" of preferred stock, bonds also are denied the wait-and-see approach. Certainly bonds can be useful as aids in the intergenerational transfer of ownership. Retireees could enjoy relatively assured, periodic payments, and newcomers might well be willing to bear the burden of senior securities in exchange for total control of the firm. Here the Code is not as generous with deferral and forgiveness as it is in the case of common stock; nor does it adopt the wait-and-see approach of preferred stock. Instead, bonds that are distributed are taxed to the recipients as if they were cash.[19] Presumably, bonds are so much more attractive than common stock that they clearly fail to fit the *Eisner v. Macomber* model, codified in section 305, in which mere changes in paper representations of wealth are deemed insufficient to trigger a taxable event.[20]

II. Defining Section 306 Stock

A. *Distinguishing Features*

Section 306(c) parenthetically excludes from the definition of section 306 stock "common stock issued with respect to common stock."[21] A statutory definition of common stock, however, is not provided. Generally, this refusal of the Code to distinguish between common and section 306 stock is not troublesome, because the nature of the bailout abuse that Congress sought to prevent by enacting section 306 provides the needed guidance. Thus, in Revenue Ruling 75-236,[22] class *A* stock, received pro rata by common shareholders in a recapitalization, was tainted as section 306 stock because it was preferred over the class *B* stock in the receipt of

[18] *See* Bittker & Eustice, *supra* note 5, at ¶ 10.03(1).

[19] Corporate obligations and securities are "property" eligible for dividend treatment. *See* I.R.C. §§ 317(a), 301(a); *see also id.* § 312(a)(2).

[20] *See* notes 1-2 *supra* and accompanying text.

[21] I.R.C. § 306(c)(1)(A). Section 306(c)(1)(B) excludes common stock from the definition of section 306 stock when such stock is received in a reorganization. *See id.* § 306(c)(1)(B).

[22] 1975-1 C.B. 106.

dividends and limited in both the amount of dividends it could receive and its liquidation rights.[23] This ruling is straightforward because the characteristics of the class *A* stock that distinguished it from the class *B* stock are precisely those that, while convenient for estate planning, are also expedient for sales to outsiders.[24] There are other cases, however, in which the ambiguity of the distinction between common and section 306 stock is disturbingly obvious. These more difficult cases often arise in the context of an "E" reorganization in which the old common stock is retired in favor of new, multiple classes, or shareholders are offered a choice among various packages of new and old shares.

In Revenue Ruling 81-91,[25] for example, the shareholders exchanged each share of common stock for one share of new class *A* stock and one share of new class *B* stock in a recapitalization. The *A* stock and *B* stock had identical par values. The class *B* shares were preferred to *A* shares because they were entitled to an annual cumulative dividend of six percent of par value before any dividend could be paid on *A* shares. Similarly, class *B* shares had a prior right to repayment up to par value in the event of liquidation. After these preferences were satisfied, each share of *A* and *B* was to share equally in dividends and liquidating distributions. Each class of shares carried equal voting rights, and neither class was redeemable.[26]

The Service held that the class *B* stock, despite its preferences, was common stock and therefore excepted from the taint of section

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[23] *See id.* at 106.

[24] The estate planning function of the class *A* stock was explained in the ruling as follows:

> By restricting the growth of the class A stock, upon the death or retirement of any of the present shareholders, the remaining shareholders will be able to purchase the class A stock for a sum within their means and control of the company will, therefore, not fall into the hands of inexperienced persons. At the same time the heirs of the deceased shareholders will share in the growth of the company through their ownership of the B stock.

Id.

Of course, the dividend preference also makes the transaction attractive to the retiring sellers, who will enjoy a cushion beneath their claims. They may wish to stipulate that corporate salaries may not be increased without the approval of the preferred shareholders as a class in order to preserve this cushion and minimize the need for policing by the preferred shareholders.

[25] 1981-1 C.B. 123.

[26] *See id.* at 123.

306.[27] This ruling came as no great surprise, because the Service previously had highlighted the importance it attaches to common stock's ability to participate in corporate growth and the *B* stock in Revenue Ruling 81-91 did enjoy a share in distributions—and therefore growth—in addition to its preferences. Although the regulations pertaining to section 306 offer no guidance on this matter, the Service may have been influenced by Regulation section 1.305-5(a),[28] which states: "The distinguishing feature of 'preferred stock' for the purposes of section 305(b)(4) is not its privileged position as such, but that such privileged position is limited and that such stock does not participate in corporate growth to any significant extent."[29]

Earlier rulings had declined to resolve section 306 questions with this single tool offered in the section 305 regulations. Instead, a variety of stock characteristics were relied upon, including redeemability,[30] existence of limitations or preferences,[31] bailout potential,[32] and relative risk and return exposures.[33] A number of recent rulings, however, have indicated the emerging and, perhaps, exclusive importance of "sharing in corporate growth" as the key distinguishing trait of common stock. Revenue Rulings 75-222,[34]

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[27] *Id.* at 124.

[28] Treas. Reg. § 1.305-5(a).

[29] *Id.* The regulations emphasize that the participation in corporate growth must be substantial. Thus, an example in the regulations classifies stock as preferred—although it shares in corporate growth—because by its terms it shares only after substantial preferences are satisfied. The earnings record, growth rate, and number of outstanding shares are such that in the year of the distribution it would be unreasonable to consider the right to share in corporate growth as imparting real value. *See id.* § 1.305-5(d), Ex. 8.

[30] *See* Rev. Rul. 57-132, 1957-1 C.B. 115 (redeemable stock not considered common stock under § 306(c)(1)(B)).Redeemability retains its vitality as a tainting feature if the redemption can be compelled by the corporate issuer. *See* Walter, *"Preferred Stock" and "Common Stock": The Meaning of the Terms and the Importance of the Distinction for Tax Purposes,* 5 J. Corp. Tax'n 211, 217 (1978).

[31] *See* Rev. Rul. 75-236, 1975-1 C.B. 106 (class of nonredeemable stock with five percent dividend preference, share in liquidation up to par value, and exclusive voting rights held section 306 stock).

[32] *See* Rev. Rul. 76-386, 1976-2 C.B. 95; Walter, *supra* note 30,at 217-18; *see also* Rev. Rul. 76-387, 1976-2 C.B. 96. Although the rulings do mention the potential for bailout, this feature is the goal of the exercise and thus not a convenient tool for distinguishing between common and section 306 stock.

[33] It seems that "relative risk" merely restates whether the stock in question shares in "unrestricted corporate growth." One ruling, however, examined the two features as if they were separable. *See* Rev. Rul. 75-222, 1975-1 C.B. 105, 105.

[34] 1975-1 C.B. 105, 105.

76-386,[35] 76-387,[36] and 79-163[37] all noted that an unrestricted interest in corporate growth is a key factor in determining whether stock is common or section 306 stock. Moreover, Revenue Ruling 75-236[38] referred directly and approvingly to the section 305 regulations in distinguishing between common and section 306 stock.[39] The emergence of "shared corporate growth" as the focal point of attempts to distinguish between common and section 306 stock has been further encouraged by one commentator who has concluded that this principle "can, with only slight modification, explain most, if not all, of the cases and rulings. . . ."[40]

Revenue Ruling 81-91 did not test the exclusiveness of the corporate growth principle because the class *B* stock enjoyed equal voting power and was not redeemable.[41] Still, it is somewhat of an exageration to conclude, as does Revenue Ruling 81-91, that "the bailout abuse that Congress sought to prevent by the enactment of section 306 cannot be effected through a sale of the class B stock."[42] After all, this class *B* stock is substantially more attractive to outside investors than typical common stock or the class *A* stock. The annual cumulative six percent dividend that precedes any payout to the *A* shareholders provides a substantial cushion for attracting potential investors. The *B* stock differs from classic section 306 stock because it shares in any distributions that can be managed by the corporation after the six percent obligation has been met. The typical outside investor, however, should discount the value of this sharing feature because the firm's managers will have a somewhat reduced incentive to perform well because they now share the "upside" returns with outsiders who own *B* stock. Thus, the six percent preference becomes an important element of protection and distinguishes this *B* stock from typical common stock. Similarly, the preference in liquidation enhances and distinguishes the *B* stock.

The *B* stock's voting power in Revenue Ruling 81-91 is a less

[35] 1976-2 C.B. 95, 96.
[36] 1976-2 C.B. 96, 96-97.
[37] 1979-1 C.B. 131, 132.
[38] 1975-1 C.B. 106.
[39] *See id.* at 106.
[40] Walter, *supra* note 30, at 225.
[41] *See* 1981-1 C.B. at 123.
[42] *Id.* at 124.

important feature for distinguishing between common and section 306 stock.[43] Certain corporate decisions may require the approval of each class of outstanding stock (voting as a class), and therefore, the issuance of a preferred stock dividend and its subsequent sale (even if the stock is redeemable by its terms) may entail the loss of some voting power by the sellers. On the other hand, a corporate charter with a simple majority voting mechanism may serve to maintain complete control in the hands of the class *A* shareholders if, when they sell *B* stock to an outsider, they retain sufficient *B* shares to maintain a majority of all outstanding shares. The inattention paid to voting rights in identifying section 306 stock, therefore, is quite sensible. Use of voting rights as a determinative feature would require an inquiry into share ownership, voting agreements, and state law and, thus, hardly would contribute to a more certain atmosphere for business planning.

B. The Potential for Abuse

The analyses contained in Revenue Ruling 81-91 and in the recent tax literature are overly simple and should encourage tax avoiders to effect classic preferred stock bailouts with a "safe harbor" modification derived from the focus on corporate growth. Specifically, the convergence of attention on the corporate growth feature of a class of stock implies that in a recapitalization, old common stock owners can be given new common and class *Z* stock which is preferred as to dividends (to the extent of a percentage of par value) but also shares in additional dividends and any liquidation payouts. This new class *Z* stock may survive as common stock and escape the taint of section 306 even if it receives as little as ten percent of all distributions beyond its preferred amount.[44] If the

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[43] *See* Rev. Rul. 76-387, 1976-2 C.B. 96, 97. The ruling discounted the difference in voting rights between two classes of stock while distinguishing common from section 306 stock. Rev. Rul. 81-91 supports its reasoning by noting that the *B* stock cannot be sold without loss of voting control. *See* 1981-1 C.B. at 124. Relative voting rights were also passed over in Rev. Rul. 57-132, 1957-1 C.B. 115, in which one class was redeemable at 110% of book value and nonvoting. In all other respects the two classes were identical. The ruling tainted the class as section 306 stock because it was redeemable. *See id.* at 115.

[44] *See* Treas. Reg. § 1.305-5(d), Exs. (8) & (9). Example (8) examines the likelihood that a preferred class of stock will participate in current and anticipated earnings and growth in evaluating its tax treatment upon distribution. It can be read to acknowledge the presence of "unrestricted growth" if *any* money beyond that committed to preferences reasonably might be available in the future. If this interpretation is correct, class *Z* stock would escape

critical requirement is an unrestricted growth feature, then class *Z* can be endowed with a right to share in distributions but remain a powerful bailout tool by virtue of its substantial preference.

This bailout potential would retain its vitality even if the Service were to modify its position and require the unrestricted growth feature to be accompanied by voting rights. It is relatively easy to endow both *Z* and new common stock with voting rights but structure the corporate charter and volume of *Z* stock so that, after a sale of the *Z* stock to an outsider in a bailout, the new common stock will retain voting control.

Although the Service's reliance on the existence of an "unrestricted growth feature" as the means of distinguishing between common and section 306 stock is thus vulnerable to abusive tax avoidance, it does not follow that Revenue Ruling 81-91 and its companions are decided incorrectly. As noted earlier, there is also room for tax avoiding bailouts through the issue of a classic common stock dividend on common stock; these new shares can be sold without the payment of an ordinary income tax by a seller who owned the underlying common stock while earnings and profits were accumulated.[45] Quite simply, a line-drawing problem came into existence once Congress decided to await distributions or sales rather than to tax shareholders on their corporations' profits as these profits accrued.[46] *Eisner v. Macomber* exacerbated this line-drawing problem: some distributions, such as classic common stock dividends, were declared exempt from the class of events that trigger the shareholder level tax.[47] Accepting these congressional and judicial decisions as given, it is difficult to know how far to extend their reach. The amount of room allowed abusive bailouts and the weight afforded the various factors that contribute to the bailout

§ 306 taint if its holders can receive, or reasonably can expect to receive, any distributions beyond the preferred amount. Ten percent, therefore, is chosen as an aggressive example rather than a dividing line.

[45] *See* notes 17-18 *supra* and accompanying text.

[46] Section 301 is an instance of congressional generosity because the economically "natural" time to impose a shareholder tax would be when the corporation's value increases and not when this increased value is physically distributed. Of course, this natural timing would require periodic appraisals of corporate assets. Instead, the Code awaits a corporate distribution (or shareholder disposition) *and* takes a lighter toll if the shareholder's gain reflects asset appreciation rather than earnings and profits.

[47] Section 305 codifies this principle. *See* I.R.C. § 305. The shareholder level tax thus is further removed from its "natural" time.

potential before the pall of section 306 is cast are issues that must be resolved. Given the economically arbitrary nature of the occasions chosen for the imposition of a tax, it is difficult to extend the few explicit instructions in the Code to cover the myriad situations that can arise.

The interesting aspect of such an analytical and intellectual dead end is that the cases which come before judges or the Service are particularly open to case-by-case inspection. When the legal standard is not "whether" but rather "to what extent" the bailout abuse that Congress sought to prevent with section 306 is present, it is tempting to set the world right with the tools of tax litigation.

C. *Revenue Ruling 66-332*

Revenue Ruling 66-332[48] provides an illustration of the case-by-case approach. A corporation with one class of common stock recapitalized so that there were three classes of stock: *A*, *B*, and Preferred. The corporation's common stock was reclassified as class *A* stock, and the shareholders could retain the class *A* stock or exchange all or part of it for class *B* and Preferred stock. The exchange ratio was one share of class *A* stock for one share of class *B* stock and one share of Preferred stock.[49] The Preferred shareholders were entitled to a cumulative dividend of seven dollars per share before any other dividend payout. On liquidation, they received preference, up to par value, on any distributions of assets. The Preferred shareholders enjoyed no voting rights except in the event of dividend arrearage.[50] The class *A* shareholders were entitled to a cumulative dividend of seven dollars per share after payment of the Preferred dividend but before any dividend payments to class *B* shareholders. Any further distribution would be paid equally to *A* and *B* shareholders. On liquidation, the holders of the class *A* stock were entitled to a distribution up to one and one-half times the amount of its par value after the liquidation payment to the Preferred shareholders but prior to any payments to the class *B* shareholders. Holders of class *A* and *B* stock then would share equally in any further liquidating distributions. The *A* sharehold-

[48] 1966-2 C.B. 108.
[49] *See id.* at 109.
[50] *See id.*

ers enjoyed voting rights.[51] The class *B* shareholders, after payment of the cumulative dividends and liquidation preferences on Preferred and *A* stock, would share equally with the holders of *A* stock in all further distributions. The *B* shareholders also enjoyed voting rights.[52]

In determining which classes of stock were tainted as section 306 stock, the Service reached a three part conclusion. With respect to shareholders who exchanged all of their class *A* stock, the Service held that the new *B* stock was common stock and the new Preferred stock was section 306 stock.[53] With regard to shareholders who exchanged only part of their class *A* stock and therefore owned *A, B,* and Preferred stock, the Service held that the *A* stock was not common stock because it had preferences over the *B* stock. Thus, both the *A* and the Preferred stock were classified as section 306 stock.[54] Finally, with regard to those shareholders who retained all of their *A* stock, the Service held that although the *A* stock was preferred in some sense, it was not section 306 stock because the transaction "was not substantially the same as [the *A* shareholders'] having received a stock dividend."[55]

It appears, at first, that the second part of the ruling deals harshly with those shareholders who exchanged only a part of their class *A* stock. It is true that both the *A* and Preferred stock were endowed with preferences that the *B* stock lacked. Therefore, both the *A* stock and the Preferred stock were more salable to outsiders in a manner that bailed out earnings and profits. The *A* stock, however, was really a substitute for the old common stock and, arguably, cannot be considered as having been received as a stock dividend.

Indeed, in Revenue Ruling 81-91 the Service disapproved of and modified this part of Revenue Ruling 66-332, albeit on somewhat different grounds.[56] The modification, in keeping with the arbi-

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[51] *See id.*

[52] *See id.*

[53] *See id.* at 110.

[54] *See id.*

[55] *Id.; see also* I.R.C. § 306(c)(1)(B)(ii); Treas. Reg. § 1.306-3(d); Rev. Rul. 60-1, 1960-1 C.B. 144. The Service determined that if cash had been received by this group in lieu of *A* stock, it would not have been taxable as a dividend. *See* 1966-2 C.B. at 110.

[56] *See* 1981-1 C.B. at 124. The Service also modified the theory, but not the result, of the third part of Rev. Rul. 66-332 on the same grounds. *See id.* at 124-25. One commentator has also disapproved of Rev. Rul. 66-332, arguing that stock entitled to preferences and a share

trary line-drawing of Revenue Rulings 79-163 and 81-91, relies on the fact that the class *A* stock could not be sold "without a loss of an interest in the unrestricted equitable growth of the corporation."[57] As such, the Service now declares that this class *A* stock is properly excepted from the definition of section 306 stock and instead is untainted common stock. Although this modification overcomes the harshness of Revenue Ruling 66-332 to those shareholders who retained some class *A* stock and found it tainted in passing, its reliance on the unrestricted growth feature is troubling.[58] As such, this article now turns to a discussion of alternative methods of distinguishing between classes of stock and then to a more complete analysis of Revenue Ruling 66-332.

III. Alternatives for Distinguishing Section 306 Stock

The "unrestricted growth" feature that the Service has used to differentiate common from section 306 stock is unsatisfying. It is too easy to design stock that contains this feature yet enjoys sufficient preferences to effect the bailouts that Congress sought to prevent by enacting section 306. There are a number of alternative methods of analysis that might be adopted.

The first and harshest of these alternatives adopts the contours of section 305, in which Congress sought to preserve the *Eisner v. Macomber* result while curbing abusive practices, such as offering shareholders the choice of a cash dividend or a tax-free stock dividend. Essentially, section 305 draws a tight circle around *Eisner v. Macomber* and taxes every part of a distribution that allows any choice or is anything but a strictly pro rata distribution on common stock. Section 306 could be analogously interpreted to define section 306 stock to include any issue that is likely to be easier to sell to outsiders than the most junior of the corporation's securities. Under such a rule, the *B* stock in Revenue Ruling 81-91 and both the Preferred and *A* stock in Revenue Ruling 66-332 would be tainted as section 306 stock.[59]

A second and more objective rule would define common stock as

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in corporate growth is not significantly different from a second class of common stock receiving dividends at a different rate. *See* Walter, *supra* note 30, at 223.

[57] 1981-1 C.B. at 124.

[58] *See* text accompanying notes 44-45 *supra*.

[59] *See* text accompanying note 61 *infra*.

any stock which had an "unrestricted share in growth" but also had *no preference* over any other class of security. Any stock not meeting this definition would be section 306 stock. Thus, for example, if, in a reorganization, the class *A* stock distributed received ten percent of all dividends and liquidating distributions and the class *B* stock distributed received ninety percent, neither would be tainted as section 306 stock under the "unrestricted share in growth" standard and neither would be tainted under the "no preference" rule. The first proposed rule, however, could be interpreted to classify the *B* stock as section 306 stock, because it might be "easier to sell." The no preference rule would taint the *B* stock in Revenue Ruling 81-91 and both the Preferred and *A* stock in Revenue Ruling 66-332.[60] Under either of the proposed rules, the question remains whether, in Revenue Ruling 66-332, those shareholders whose old stock was merely converted into *A* stock, received the *A* stock in a transaction substantially equivalent to a stock dividend.[61]

Although these suggested rules may seem unduly harsh, it should be recalled that the section 306 taint was intended as a

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[60] Both proposed rules would taint the hypothetical *Z* stock developed earlier to abuse the emerging standard of unrestricted growth. *See* text accompanying note 44 *supra*.

[61] *See* note 55 *supra* and accompanying text. Note that the "no preference" requirement can be interpreted to refer to a comparison between the stock in question and any other class of stock held by the *same* shareholder, in which case this second rule produces the identical result as that reached in Revenue Ruling 66-332. In any event, the tainting of the retained shares may be of no significance; on disposition of the entire holding, capital gains treatment still may be available because the seller owns no common (*B*) stock and his interest, therefore, is terminated. Section 306(b)(1) provides that if the disposition terminates the shareholder's stock interest, is not a redemption, and is not to a related shareholder, then the ordinary income treatment normally triggered by a disposition of section 306 stock is not required. *See* I.R.C. § 306(b)(1). Arguably, if the disposition of the tainted stock follows, rather than accompanies, the termination of the common stock interest, the same result is appropriate. *See* Treas. Reg. § 1.306-2(b)(3); Bittker & Eustice, *supra* note 5, at ¶ 10.05(1).

In view of the text's analysis of Rev. Rul. 66-332 which follows, the better approach in the context of a recapitalization would seem to be a less literal reading of § 306(b)(1) and a refusal to give capital gains treatment on a disposition (of the *A* stock) that follows the termination of the shareholder's common stock interest. The logic of the Bittker & Eustice approach, which implies that it is the entire *common* interest that must be terminated revolves around a shareholder's ability, in the typical case, to first sell his common stock and then acquire clearly untainted preferred stock. This strategy, however, is not available in a recapitalization, so that if the disposition of section 306 stock follows the termination of the common stock interest, the Service might claim ordinary income treatment and find § 306(b)(1) inapplicable.

check to insure that taxpayers do not abuse the congressional sympathy for estate planning problems.[62] It is difficult, for example, to comprehend just how the recapitalization that is the subject of Revenue Ruling 66-332 could be important for business reasons or estate planning. A retiring seller is not likely to want a package of the most preferred stock and the most junior stock, yet that is the package offered in the exchange.[63] Similarly, Revenue Ruling 81-91 simply states that there were valid business reasons for the recapitalization[64] but does not indicate that the *B* stock's six percent preference was necessary to fulfill that business need. If the Service is to continue using its incomplete analysis to distinguish between section 306 and common stock, then, at the very least, it should examine for and insist on valid business reasons for the preferences attached to any stock that will go untainted. It is suggested, however, that the Service's "unrestricted growth" test be augmented with a "no preference" requirement. Such a rule, among other things, would provide a more certain atmosphere for business decisions and a more administrable standard for the Service.

IV. Another Look at Revenue Ruling 66-332

A. *The Underlying Transaction*

Revenue Ruling 66-332 did incorporate the "no preference" requirement into the test for section 306 stock, and inspection of the underlying transaction suggests that the ruling was decided correctly and in no need of modification. Recall that each shareholder was offered the option of retaining class *A* stock (old common stock) or exchanging a share of *A* stock for one Preferred and one *B* share.[65] The typical shareholder might be expected to reason as follows: If the corporation's future earnings and financial policy are expected to yield a dividend of less than $14 a year, then the exchange is beneficial. The first $7 will be paid to the Preferred shareholders and the remaining amount will be paid to the *A* shareholders; therefore, a package of one Preferred and one *B*

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[62] *See* note 15 *supra* and accompanying text.
[63] *See* 1966-2 C.B. at 109.
[64] *See* 1981-1 C.B. at 123.
[65] *See* note 49 *supra* and accompanying text.

share is superior to one *A* share.[66] If $14 is the expected distribution, then the exchange is an even one in terms of dividend rights. Finally, if a dividend of more than $14 is expected, the exchange remains even, because the Preferred and *A* shareholders will each receive $7 and additional payments will be divided equally between the *A* and *B* shareholders.

From an analysis of the dividend rights available in the exchange offer, it appears that the rational shareholder will exchange his *A* stock for the package of Preferred and *B* stock. If dividend payments are $14 or more, he is indifferent between the two packages, but if an annual distribution is less than $14, the package of Preferred and *B* stock is more valuable than the retained *A* stock. The voting rights attached to the two packages, of course, are equal.

Upon liquidation, the Preferred shareholders are entitled to distributions up to the stock's $100 par value, after which the *A* shareholders receive distributions up to one and one-half times the stock's $100 par value. Finally, the *A* and *B* shareholders share equally in any residual.[67] Therefore, if the expected liquidation distribution is $100 per share on the Preferred and *A* stock outstanding, the exchange is an even one in terms of liquidation distributions. If a distribution of less than $100 per share on the *A* stock is expected, then the package of Preferred and *B* stock is superior to retained *A* stock. Finally, if a distribution of more than $100 per share is expected, retained *A* stock becomes more attractive. Assuming that the typical shareholder expects the corporation to continue as a going concern, the rational shareholder will be less concerned with liquidation rights than with dividends. Consequently, the choice of the Preferred and *B* stock package over *A* stock is a clear one.

Considering the preceding analysis, those shareholders who exchanged none of their *A* shares or only a part of their *A* shares

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[66] The analysis assumes that shareholders prefer current dividend distributions to cumulating arrearages. Otherwise, the *A* stock and Preferred stock are equally attractive, in terms of dividend rights, because both are entitled to cumulative dividends. The preference for current payouts—and not cumulated ones—stems from the fact that dividends rarely, if ever, cumulate at the going rate of interest and continue to bear the risk of nonpayment.

[67] *See* 1966-2 C.B. at 109. Although the par value of the *A* stock is not stated explicitly, the common for which the *A* was substituted had a par of $100, the same as that of the new preferred. *See id.*

appear to have acted irrationally. There may be other considerations, however, that play a role in the decision. Assume that there exists a group of insiders that owns only a small percentage of the outstanding shares but that would like to obtain voting control (or at least veto power) within the firm. The exchange described in Revenue Ruling 66-332 can be viewed as a brilliant scheme to acquire such power, as long as the corporate charter or bylaws require voting by class for important decisions or for the election of directors.[68] In the extreme case, all of the shareholders who are not part of this insider group will do their arithmetic correctly and will exchange *A* shares for the package of Preferred and *B* shares. The insiders, of course, will refuse the exchange. In one quick maneuver, these insiders will have advanced from minority ownership to fifty percent control.

In reality, some non-insiders will retain their *A* shares. The supervision and timing of the exchanges, however, favor the insiders' scheme. As the exchange deadline nears, the insiders may be able to monitor the responses of most of the other shareholders and estimate the number of *A* shares that must be retained to control the voting of *A* stock. As the exchange offer is accepted, and it becomes clear that this number is smaller and smaller, the insiders also can exchange some *A* shares and develop a formidable minority voting bloc in class *B*. Such a bloc may be important if the charter or bylaws leave some decisions to "supermajority" (two-thirds, for example) vote by class.[69] More importantly, if the directors of the corporation are elected by class, with an equal number of seats reserved for each class, and cumulatively within each class, the insiders may be able to elect a majority, not just one-half, of

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[68] Class voting is often required to approve critical decisions, such as amendments to the articles of incorporation. *See* H. Henn, Law of Corporations § 348, at 720-21 (2d ed. 1970). Many statutes delegate the discretion for instituting and circumscribing class voting to corporate bylaws or articles of incorporation. *See, e.g.*, Del. Code Ann. tit. 8, § 151(a) (1974); N.Y. Bus. Corp. Law § 617(a) (McKinney 1963).

[69] Some state corporation laws establish supermajority voting as the norm for certain actions. *See, e.g.*, N.Y. Bus. Corp. Law § 909(a) (McKinney 1963) (sale of substantially all assets outside regular course of business requires approval of ⅔ of shares entitled to vote); *id.* § 1001 (McKinney 1963) (⅔ vote required for dissolution). These laws, however, generally permit the articles of incorporation to override statutory voting percentages. *See id.* §§ 616, 1002 (McKinney 1963). Other state corporation laws retain majority rule as the norm but allow the articles of incorporation to establish supermajority requirements. *See, e.g.*, Del. Code Ann. tit. 8, §§ 216, 271(a), 275(b) (1974).

the board members.

The plan that is the subject of Revenue Ruling 66-332 could well be an innocent recapitalization. Nevertheless, it also is a remarkably potent tool for turning a minority ownership into one that controls fifty percent or more of the corporation's votes. Moreover, the common shareholders cannot be expected to exchange shares in a manner that foils the power play. It will be expensive for them to organize, and it is unlikely that they will agree on the proper defensive strategy and then trust one another to carry it out.[70] In any event, the insiders probably will be able to await the decisions of a large majority of the outstanding shareholders and then react accordingly.[71] At worst, the recapitalization into classes will fail to develop as the insiders had hoped and they will be no worse off than when they began; they will be minority owners in two classes of voting stock and one class of preferred, whereas previously they had been the minority in one class of voting stock.

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[70] If, for example, directors are elected cumulatively and by class, it is dangerous for a shareholder to agree not to exchange *A* stock because he will risk dilution of his voting power if his cohorts all go through with the exchange. In short, the non-insiders will be concerned with strategic behavior among themselves and therefore are unlikely to be effective in their opposition to the insiders' scheme.

[71] Assume, for example, that it appeared that the great majority of non-insiders would retain the *A* stock. Just before the exchange deadline, the insiders could exchange enough *A* shares to control class *B*, but leave themselves a significant minority voting bloc in class *A*. Thus, the insiders still could achieve majority control. As a bonus, they also would profit from the dividend benefit originally intended to induce non-insiders to exchange. *See* note 67 *supra* and accompanying text. Only a highly organized and well executed plan, in which non-insiders who own at least two-thirds of all shares split their strength to maintain control in each class, can defeat the power play. Such a development is unlikely. *See* note 70 *supra* and accompanying text.

Note the awesome power of the well-organized minority. Assume, for example, that the earlier conjecture regarding the importance of liquidation rights is incorrect and that the rational shareholder faced with the recapitalization plan seeks to profit from a liquidation of considerable size. Thus, he prefers *A* stock because he will receive $150 per share and then a portion of the residual. A package of Preferred and *B* stock would yield only $100 and then an equal portion of the residual. If many shareholders reason this way and choose *A* stock, the insiders will enjoy a majority of *B* and a minority of *A*. As *B* shareholders, they will block the liquidation that benefits the *A* class. Again, only an extremely well organized, and deep-pocketed, group of shareholders could thwart the insiders' plan. They would hope to keep their own members in line and cause just the right number to choose the package so that the insiders will fail to gain voting control in any class. It will be almost impossible to engineer such a plan—especially given the fact that timing is on the side of the insiders—because the shareholders who choose *A* stock must be convinced that the corporation never will pay less than $14 in dividends.

B. The Role of the Service

In view of the potential abuse inherent in this clever scheme, the Service thwarted the plan by properly classifying a portion of the *A* stock as section 306 stock.[72] The treatment of shareholders who exchange all of their *A* stock for Preferred and *B* stock is preordained by section 306 and the circumstances.[73] In addition, the disinclination to taint the *A* stock owned by those shareholders who did not participate in the exchange is strong. After all, there must have been some shareholders who were not vying for control with the insiders and who either did their arithmetic incorrectly or did nothing at all. For this group to lose on the exchange *and* to have its shares tainted would surely be an insensitive result.[74] Revenue Ruling 66-332 reaches this result by noting that although the *A* stock developed some preferences in the recapitalization, it was not received in a transaction substantially equivalent to a stock dividend.[75] Revenue Ruling 81-91 reaches this result on the grounds that the *A* stock had "an interest in the unrestricted growth of the corporation."[76] As argued earlier, not only is this reasoning susceptible to bailout abuse,[77] but also it is less true to the statutory language than that of Revenue Ruling 66-332.[78]

The Service is left with the question of the proper treatment of those shareholders who exchanged only a part of their *A* stock for the package of Preferred and *B* stock. It now should be clear that forcing a taint on the Preferred *and A* stock was an ingenious stroke. Essentially, the Service discouraged what might have been a successful self-dealing scheme by denying capital gains treatment on future sales of *A* stock (the old common) by the corporation's insiders. The drafters of the ruling may have been confident that

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[72] Whether the Service should do anything at all about what is essentially a corporate fiduciary duty problem is a question that admits of no simple answer, and none is attempted here.

[73] *See* I.R.C. § 306(c)(1)(B); Rev. Rul. 66-332, 1966-2 C.B. at 110.

[74] It is also possible that exchanges could occur after the Revenue Ruling appeared. In this case, a ruling that tainted the *A* stock in the hands of those who exchanged none at all only would have helped the insiders' plan; non-insiders would quickly exchange and the success of the insiders' scheme would be assured, albeit at the expense of ordinary income on the disposition of the A stock.

[75] *See* 1966-2 C.B. at 110.

[76] 1981-1 C.B. at 124.

[77] *See* note 44 *supra* and accompanying text.

[78] *See* note 55 *supra* and accompanying text.

while only an unconventional reading of section 306 would agree completely with the ruling, it was unlikely that the insiders would go into court and subject their plan to inspection and publicity. To be sure, the Service may not have speculated along the lines suggested in this article but may have been uneasy about the peculiar structure of the recapitalization; as such it decided to construe section 306 strictly to avoid a potential bailout. In any event, Revenue Ruling 66-332 represents an effective application of the Service's powers to prevent abuse of the corporate structure.

V. Conclusion

The definition of section 306 stock generally has been developed on a case-by-case basis. It appears from Revenue Ruling 81-91 that the Service now relies primarily, if not exclusively, on the "unrestricted share of corporate growth" criterion to distinguish common from section 306 stock. The addition of a "no preference" requirement to the section 306 stock test would promote certainty, ease Service review, and, most importantly, minimize the bailout potential which now exists. The "no preference" criterion may also provide the Service with a valuable means of ruling equitably in unusual circumstances, such as Revenue Ruling 66-332.

Revenue Ruling 66-332 had never been cited in a court opinion or other Service ruling. It is, after all, not an opinion about corporate tax so much as it is about the potential for virtually undetectable fiduciary breaches. For better or worse, Revenue Ruling 81-91 has awakened this sleeping beauty in an innocent, but perhaps myopic way, thereby motivating this article to speculate about its hidden story.

Some readers will doubt that this article has been correct in perceiving the essence of Revenue Ruling 66-332. Their instincts may be right, in which case the anonymity of these rulings is gratifying. Others will agree that the evidence is strong and that the exchange offer was bizzare enough to support the interpretation offered in this article, but will doubt that the Service had all this in mind. They also may be correct, but then what harm can there be in building legends around pedestrian tax rulings? Finally, a third group of readers may accept the analysis but object to the underhanded way of serving justice that is represented in Revenue Ruling 66-332. This objection is a serious one and not far removed from debates concerning statutory and constitutional construction.

Perhaps sleeping beauties should be allowed their uninterrupted rest.